The Commonwealth of Massachusetts

DEPARTMENT OF
TELECOMMUNICATIONS AND ENERGY

October 27, 2004

D.T.E. 04-48

Petition of Fitchburg Gas and Electric Light Company for approval of tariffs to provide recovery for costs associated with its obligations to provide employees pension benefits and post-retirement benefits other than pensions.

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FOR: FITCHBURG GAS AND ELECTRIC LIGHT COMPANY
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TABLE OF CONTENTS

I. INTRODUCTION

On April 30, 2004, Fitchburg Gas and Electric Light Company ("Fitchburg" or "Company") filed with the Department of Telecommunications and Energy ("Department") tariffs that establish an annual adjustment factor to recover costs associated with the Company's pension and post-retirement benefits other than pensions ("PBOP") obligations that are not currently being collected in base rates. The Company stated that its proposal provides for the recovery of the regulatory deferrals approved by the Department in Fitchburg Gas and Electric Light Company, D.T.E. 03-131 (2004). The Company's tariffs listed an effective date for its annual adjustment factor of November 1, 2004 for its gas division and January 1, 2005 for its electric division. The Department docketed this matter as D.T.E. 04-48.

II. PROCEDURAL HISTORY

On June 29, 2004, pursuant to notice duly issued, the Department conducted a public hearing. The Attorney General of the Commonwealth ("Attorney General") intervened pursuant to G.L. c. 12, § 11E.

On August 17, 2004, the Department held an evidentiary hearing. In support of its proposal, the Company sponsored the testimony of Laurence M. Brock, controller of the Company and vice-president and controller of Unitil Service Corp. ("Unitil Services").[1] The evidentiary record includes 21 exhibits and six responses to record requests. The Company and the Attorney General submitted briefs on August 30, 2004 ("Company Brief" and

[1] Unitil Services provides management services to Fitchburg and other affiliates of the Company's parent, Unitil Corporation (Tr. at 5).

"Attorney General Brief," respectively) and submitted reply briefs on September 3, 2004 ("Company Reply Brief" and "Attorney General Reply Brief," respectively).[2]

III. DESCRIPTION OF COMPANY'S PROPOSAL

In Fitchburg Gas and Electric Light Company, D.T.E. 02-83 (2002), the Department approved the Company's request for an accounting ruling permitting it to record the Additional Minimum Liability[3] associated with the Company's pension obligations as a regulatory asset under accounting rules. In D.T.E. 03-131, the Department approved the Company's request for an accounting ruling permitting it to defer and record as a regulatory asset or liability the difference between the actuarially-determined costs according to Statement of Financial

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2 On September 7, 2004, Fitchburg filed a motion to strike a portion of the Attorney General's Reply Brief that refers to Boston Edison Company/Commonwealth Electric Company/Cambridge Electric Light Company/ NSTAR Gas Company, D.T.E. 03-47-A (2003), claiming the reference is an attempt to introduce new facts and theories into this proceeding. In its case in chief, however, Fitchburg relies heavily on D.T.E. 03-47-A to justify its request. It is inconsistent to complain when the Attorney General refers to D.T.E. 03-47-A as well. Further, the Department may take administrative notice of materials filed in one of its dockets, according it the weight it deserves. Therefore, we deny the Company's motion to strike.

3 The Additional Minimum Liability consists of two components: (1) the difference between a pension plan's accumulated benefit obligation (i.e., the actuarially-determined present value of plan benefits based on employee service rendered and compensation paid before a specified date) and the fair value of plan assets available to provide these benefits to employees; and (2) the removal from the balance sheet, i.e., the write-off, of the prepaid pension balance (Exh. DTE-1, at 12-13, 96-97; Tr. at 73-74).

Accounting Standards No. ("SFAS") 87[4] and SFAS 106[5] and the pension and PBOP amounts currently being collected in base rates.

In this proceeding, the Company proposed a mechanism for the recovery or repayment of the regulatory deferral established by the Company pursuant to the Department's Order in D.T.E. 03-131 (2004). The Company proposed a pension adjustment factor ("PAF") that is calculated separately for its gas and electric divisions and consists of three components: (1) the Reconciliation Adjustment; (2) Carrying Charges; and (3) the Past Period Reconciliation Amount (Exh. FGE-1, exh. LMB-1, at 26). The sum of these three components is divided by the forecast unit sales (in therms or kilowatthours ("KWH")) to arrive at the PAF for the upcoming year (id.). The Company proposed that the PAF be reconciled on an annual basis (id. at 29). The gas division PAF is reconciled as part of Fitchburg's annual Local Distribution Adjustment Clause ("LDAC") filing, and the electric division PAF is reconciled as part of its annual transition charge reconciliation filing (id.).

To explain how the PAF works, Fitchburg detailed how the PAF is determined for the upcoming year. First, the Reconciliation Adjustment component is determined by taking the December 31, 2003 unamortized reconciliation deferral of $412,510 ($197,998 (gas) and

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4 In December 1985, the Financial Accounting Standards Board issued SFAS 87, effective 1987, which established new accounting standards that significantly changed the manner in which companies account for their obligations relating to employee pensions (Exh. DTE-1).

5 In December 1990, the Financial Accounting Standards Board issued SFAS 106, effective 1993, which established accounting standards similar to pensions for PBOP (Exh. DTE-2).

$214,512 (electric)) and adding the 2004 forecast pension and PBOP expenses of $2,099,010 ($831,409 (gas) and $1,267,601 (electric)) less $594,677 ($202,272 (gas) and $392,404 (electric)) in pension and PBOP expenses included in rates (Exh. DTE-9, at 4; Tr. at 6-7). The resulting reconciliation balance ("Reconciliation Balance") of $1,916,843 ($827,135 (gas) and $1,089,708 (electric)) is amortized over a three-year period (Exh. DTE-9, at 4; Tr. at 101). This produces a Reconciliation Adjustment component of $275,712 for its gas division and $363,236 for Fitchburg's electric division (Exh. DTE-9, at 4).

Second, the Carrying Charges component is computed by first taking the weighted average cost of capital of 8.5 percent, determined in the Company's last rate case, Fitchburg Gas and Electric Light Company, D.T.E. 02-24/25 (2002), and converting it to a pre-tax weighted cost factor of 11.10 percent (Exh. FGE-1, Sch. LMB-6). Fitchburg applies the pre-tax factor to the unamortized Reconciliation Balance of $1,916,843 ($827,135 (gas) and $1,089,708 (electric)) less associated deferred income taxes of $728,975 ($314,559 (gas) and $414,416 (electric)), producing a net carrying charge on the unamortized Reconciliation Balance of $131,853 ($56,896 (gas) and $74,957 (electric)) (Exh. DTE-9, at 4). Next, the Company determines the average prior years' combined prepaid pension and PBOP costs of $2,947,799 ($1,225,400 (gas) and $1,722,399 (electric)), less associated deferred income taxes of $1,121,048 ($466,020 (gas) and $655,028 (electric)) (id., lines 15 and 20).[6] The resulting net balance of $1,826,751 ($759,380 (gas) and $1,067,370 (electric)) is also multiplied by the pre-tax cost of capital factor described above (id., lines 16 and 21). This produces a carrying

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6 Prepaid pension and PBOP balances are combined for purposes of this calculation.

charge for the average prepaid amount component of $202,769 ($84,291 (gas) and $118,478 (electric)) (id. at 4). The sum of the unamortized Reconciliation Balance carrying charges of $131,853 ($74,957 (electric) and $56,896 (gas)) and the average prepaid amount carrying charges of $202,769 ($84,291 (gas) and $118,478 (electric)) produces the Carrying Charges component of $334,623 ($141,187 (gas) and $193,436 (electric)) (id.).

Third, the Past Period Reconciliation Amount represents the difference between the amount of revenue collected through the PAF and the amount of the actual pension/PBOP adjustment for the prior year (Exh. FGE-1, exh. LMB-1, at 28). Because this is the first year of the Company's proposed PAF, the initial balance is zero for both the gas and electric divisions (Exh. DTE-9, at 4).

According to Fitchburg, the total forecast pension/PBOP adjustment for Fitchburg's gas division is $416,899 (id.). This amount, divided by forecast 2005 sales of 26,122,700 therms, results in a PAF factor of $0.0160 per therm (id.).[7]

Fitchburg explained that the total forecast pension/PBOP adjustment for Fitchburg's electric division is $556,672 (id.). This amount, divided by forecast 2005 sales of 547,191,749 KWH, results in a PAF of $0.00102 per KWH (id.).

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[7] Fitchburg's forecast 2005 sales period is November 1, 2004 through October 31, 2005.

IV. POSITIONS OF THE PARTIES

A. Attorney General

The Attorney General opposes Fitchburg's proposed pension adjustment mechanism. He contends that it is contrary to Department policy and would result in significant over-collection of pension and PBOP expenses from the Company's ratepayers (Attorney General Brief at 1). The Attorney General notes that the Company's proposed formula contains complicated variables that are subject to a considerable degree of subjectivity in their calculation (Attorney General Reply Brief at 2). The Attorney General maintains that the Department has already considered and recognized the volatility of factors used to calculate pension and PBOP obligations in the Company's last rate case (Attorney General Brief at 3).

The Attorney General contends that Fitchburg has failed to support its allegation of severe financial harm, which is required to obtain the relief sought (id. at 5). Specifically, the Attorney General estimates that the corporate reorganization of Unitil Corporation, Fitchburg's parent, which occurred at the end of 2002, will produce annual savings for Fitchburg of approximately $920,000 (id. at 5, n.3, citing Exhs. AG-5, at 12; DTE-9, at 6). Claiming that the Company withheld this corporate reorganization information from the Department during the evidentiary hearings in D.T.E. 02-24/25, the Attorney General urges the Department to reject Fitchburg's proposed reconciling mechanism in its entirety and sanction the Company for "selectively disclosing" its cost increases and decreases (Attorney General Brief at 5-6).

The Attorney General also claims that by proposing a pension adjustment mechanism, Fitchburg is attempting to recover rate base costs deferred just days after the Department's decision in D.T.E. 02-24/25, at 114-117, thereby "pancaking" rate cases[8] in violation of well-established Department policy (id. at 3-4, citing Massachusetts Electric Company, D.P.U. 19257, at 7, 10 (1977)). According to the Attorney General, Fitchburg's request to recover pension and PBOP costs represents an improper attempt to recover deferred expenses in the same manner as the Department identified and rejected in D.T.E. 03-47-A at 32-33 (Attorney General Brief at 4, n.2).[9] Thus, he concludes that Fitchburg's pension and PBOP costs do not constitute a type of cost appropriate for "pass-through" mechanism of the type found acceptable by Supreme Judicial Court (Attorney General Reply Brief at 1, citing Consumers Organization for Fair Energy Equity v. Department of Public Utilities, 368 Mass. 599, 602 (1975)).

Turning to the components of Fitchburg's proposed PAF, the Attorney General contends that the Company's proposed PAF computation contains a number of errors and omissions, warranting denial of the proposed PAF (Attorney General Brief at 6).[10] First, the Attorney General argues that Fitchburg failed to capitalize any of its PBOP transition obligation, in contravention of the accounting rules of both the Department and the Federal

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8 "Pancaking" refers to a rate increase request based upon a test year that overlaps a test year the applicant previously relied on in a prior rate increase request. See, e.g., Massachusetts Electric Company, D.P.U. 19257, at 5-6 (1977).

9 In D.T.E. 03-47-A at 32-33, the Department rejected recovery of pension and PBOP costs that Boston Edison Company, Commonwealth Electric Company, Cambridge Electric Light Company, and NSTAR Gas Company incurred during a rate freeze.

10 While opposing Fitchburg's proposed reconciling mechanism, the Attorney General's brief provides what he considers to be more appropriate methods that the Department could direct the Company to apply in its PAF computation.

Energy Regulatory Commission (id. at 6-7, citing Exh. DTE-11; 18 C.F.R. § 1.101, Electric Plant Instruction No. 3). The Attorney General contends that, because the Company has chosen to recognize its transition obligation as a current expense, accounting consistency requires Fitchburg to capitalize a portion of its actual amortization of its transition obligation (Attorney General Brief at 7).

Second, the Attorney General argues that the Company has failed to credit ratepayers for the reduction in carrying charges associated with its share of Unitil Service's pension and PBOP accruals (id. at 7). Specifically, the Attorney General contends that the Company has failed to credit $736,029 in pension and PBOP accruals for 2003, as well as $1,251,715 in pension and PBOP accruals for 2004 (id. at 8). According to the Attorney General, if the Company is to be allowed to recover any Unitil Services-related pension and PBOP costs, then it must pass on the benefits of these accruals to ratepayers through the PAF (id.).

Third, the Attorney General maintains that the Company should not be allowed to recover carrying charges associated with prepaid pension and PBOP costs, because ratepayers had been denied the benefits associated with the net income from the Company's pension funds (id. at 9). The Attorney General argues that, because Fitchburg removed pension income from its cost of service in D.T.E. 02-24/25, it would be inequitable to charge ratepayers for carrying charges on any prepaid pension and PBOP balances (id., citing Exh. AG-1, at 1, 3). The Attorney General distinguishes his proposed treatment from that accorded in D.T.E. 03-47-A, at 36-38, and Boston Gas Company, D.T.E. 03-40, at 311-312 (2003), stating that in these two cases, the utility companies did not reduce their pension income to zero (Attorney General Brief at 9).

Fourth, the Attorney General contends that Fitchburg failed to allocate any pension and PBOP costs to the Company's transmission function (id. at 9-10, citing Exh. AG-4). Noting that the Electric Restructuring Act[11] requires electric companies to unbundle their transmission and distribution functions, the Attorney General concludes that Fitchburg should be directed to adjust its PAF to remove those pension and PBOP costs associated with the Company's transmission service (Attorney General Brief at 9-10, citing G.L. c. 164, § 1A(b)(1)).

Fifth, the Attorney General argues that Fitchburg has understated the expected return on equity securities in its pension and PBOP trust funds (Attorney General Brief at 10). Noting that the Company's trust funds are invested in equity securities of the Standard and Poor's 500 Companies, which carry a greater business risk than an electric distribution company such as Fitchburg, the Attorney General proposes that the expected return on plan assets used in the PAF should be increased to 11.3 percent (id. at 11-12).[12] In the alternative, the Attorney General alludes to the possibility that the Department could reduce the Company's

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[11] An Act Relative to Restructuring the Electric Utility Industry in the Commonwealth, Regulating the Provision of Electricity and Other Services, and Promoting Enhanced Consumer Protection Therein, signed by the Governor on November 25, 1997 ("Restructuring Act") St. 1997, c. 164.

[12] The Attorney General's proposed return on plan assets is determined by first taking the 10.0 percent allowed return on equity allowed in D.T.E. 02-24/25, and then adding a risk spread of 1.3 percent (Attorney General Brief at 11-12). The risk spread is based on the Attorney General's analysis of the risk premium analysis used by Fitchburg in D.T.E. 02-24/25 (Attorney General Brief at 11-12).

return on common equity ("ROE") to a number that more closely matches the return on plan assets used to calculate pension and PBOP costs (id. at 10-11).

Finally, the Attorney General argues that the Company has incorrectly assumed that its proposed 2004 PAF components constitute known and measurable amounts (id. at 12). Because the Company will not close its 2004 books out until sometime in early 2005, the Attorney General contends that Fitchburg would still have to reconcile its PAF to actual pension and PBOP costs sometime in the future (id. at 12, citing Tr. at 20).

B. Fitchburg

Fitchburg defends its proposed pension adjustment mechanism as consistent with both Department ratemaking standards generally and recent precedent on the ratemaking treatment of pension and PBOP costs (Company Brief at 13-16; Company Reply Brief at 2-7). The Company contends that it has satisfied the Department's standard of review for pension and PBOP reconciliation mechanisms, as set forth in D.T.E. 03-40, at 308-309 (Company Reply Brief at 6-7).

Fitchburg argues that the disallowance of the PAF would have material consequences to its operations (Company brief at 16-17; Company Reply Brief at 9-10). The Company contends that without the PAF, it would be required to write off $284,008 in 2003 pension and PBOP deferrals on an after tax basis, representing more than ten percent of its total electric and gas distribution ROE authorized by the Department (Company Brief at 16-17; Company Reply Brief at 9-10). Moreover, the Company argues that, in the absence of a PAF, it would incur an additional $1.5 million per year in additional annual pension and PBOP expense amounts, representing over 15 percent of its total O&M expense included in base rates (Company Brief at 17). According to the Company, this would result in a significant financial impact on its ratepayers, through the potential for increases in base rates and the potential for reduced service quality resulting from being served by a financially-strapped utility (id. at 17; Company Reply Brief at 12-13).

Concerning the Attorney General's argument that cost savings achieved through the 2002 Unitil reorganization warrants denial of the Company's request, Fitchburg maintains that the Attorney General has distorted the record (Company Reply Brief at 13). According to the Company, the reorganization plan was first considered by Unitil Corporation in November 2002, five months after the Company's response to the Attorney General's data request in D.T.E. 02-24/25 for all "audits," and after the Department's decision in that proceeding (id. at 16-17). The Company maintains that the Attorney General's claim of $920,000 in savings for Fitchburg is mere conjecture and inconsistent with the savings estimate provided during the proceedings (id. at 13, citing RR-AG-1). Fitchburg claims that it did not reference reorganization savings in its request for an accounting deferral because (1) there were no net operation and maintenance ("O&M") savings during 2003, (2) O&M expense levels were irrelevant to the request for an accounting deferral, and (3) Unitil Corporation's net O&M expense actually increased by a total of $2.2 million, or 11.2 percent, during 2003 (Company Reply Brief at 14, citing Exh. AG-6, at 20). Furthermore, Fitchburg maintains that both Unitil Corporation and Fitchburg have continued to make significant investments in the Company, including capital projects, cast iron main replacement, and distribution upgrades (Company Reply Brief at 15-16).

The Company argues that it is not seeking a base rate increase based upon an overlapping test year, nor is it seeking to relitigate issues decided in its last rate case (id. at 5, 7). Fitchburg argues that the Department's policy against "pancaking" rate cases is actually a prohibition against overlapping test years (Company Reply Brief at 8, citing D.P.U. 19257, at 5-6; Boston Edison Company, D.P.U. 18515 (1976)). The Company maintains that it is not attempting to apply overlapping test years to determine base rates, nor seeking emergency rate relief (Company Reply Brief at 5). Rather, Fitchburg contends that is merely seeking to remove a volatile cost element from base rates for annual reconciliation and recover no more and no less than its actual cost associated with providing pension and PBOP benefits to employees (id.). The Company distinguishes its situation from the Department's denial of a portion of pension and PBOP costs in D.T.E. 03-47-A, noting that its proposed treatment is consistent with the Department's decision there to allow recovery of pension and PBOP costs incurred by the NSTAR companies after the end of the four-year rate freeze period implemented in Boston Edison/ComEnergy Acquisition, D.T.E. 99-19 (1999) (Company Reply Brief at 10-11, citing D.T.E. 03-47-A at 32-33).

Turning to the Attorney General's arguments concerning specific elements of the PAF, Fitchburg first argues that it has properly calculated its annual amortization of PBOP costs (Company Reply Brief at 17). The Company contends that it is currently capitalizing 41.17 percent of its labor-related costs to construction overheads, and that requiring the allocation of additional costs would result in an overallocation to capital and the charging of prior period PBOP costs to current construction overheads (id. at 18).

Fitchburg opposes the Attorney General's proposed adjustment for Unitil Services' pension and PBOP accruals. The Company maintains that none of Unitil Services' assets or liabilities are allocated to Fitchburg, or used in the development of its cost of service (id. at 18). Fitchburg argues that Unitil Services' accrued pension and PBOP liabilities represent obligations to provide pension and PBOP benefits to employees of Unitil Services, not amounts that are owed to the Company's ratepayers (id. at 19). Consequently, the Company considers its proposed treatment of Unitil Services' pension and PBOP accruals to be appropriate (id.).

The Company contends that the Attorney General's arguments on carrying charges associated with prepaid pension and PBOP costs are illogical, because there is no connection between pension expense and the purpose of carrying charges (id. at 20). The Company maintains that carrying charges are intended to compensate utilities for the time value of money resulting from the delay in rate recovery of significant expenditures (id. at 20, citing D.T.E. 03-47-A at 37 (2003)). Fitchburg maintains that it should not be penalized because its pension expense in the test year was lower than that incurred by other companies (id. at 21).

Fitchburg contends that it has properly attributed a portion of its pension and PBOP expense to its transmission function (id.). Concerning its prepaid pension and PBOP balances, the Company argues that its proposed allocation method is administratively efficient and consistent with both the Department's directives and the requirements of the Electric Restructuring Act (id. at 22).

Fitchburg argues that the Attorney General's argument concerning the return on plan assets fails to recognize the distinction between the return on plan assets and ROE, and constitutes an attempt to introduce testimony on brief through the "cobbling together" of unrelated calculations that were previously rejected by the Department in D.T.E. 02-24/25 (id.). The Company maintains that a return on plan assets is a consolidated return for both debt and equity investments used in the valuation of pension plan assets, and is determined in accordances with the requirements of SFAS 87 and other actuarial assumptions involving long-term investment yields (id. at 23-25). In contrast, the Company notes that a utility's ROE represents compensation to investors for the risks associated in purchasing equity shares, and is determined in base rate proceedings based on various empirical models and consistent with judicial standards (id. at 23-24). Fitchburg points out that the Attorney General relies on a risk premium model that he had opposed in the Company's last rate case, and that the Department had not relied upon (id. at 25-26). The Company dismisses the Attorney General's suggestion that its allowed ROE should be reduced as unsubstantiated, claiming that the argument is based on erroneous assumptions not supported by credible evidence (id. at 26).

V. ANALYSIS AND FINDINGS

A. Introduction

The threshold issue in this matter is whether it is appropriate to consider changing the manner in which Fitchburg collects its pension and PBOP costs. Presently, Fitchburg recovers some of its pension and PBOP costs through base rates. It now requests that we also adopt a pension and PBOP reconciling mechanism that operates outside of base rates.

While the Department has not endorsed a specific method for the calculation of pension and PBOP expenses for ratemaking purposes, it has always sought to include amounts that allow for just and reasonable rates. See, e.g., Boston Gas Company, D.P.U. 96-50 (Phase I) at 81; Bay State Gas Company, D.P.U. 89-81, at 33-34 (1989). Our recent precedent allows pension adjustment mechanisms in cases where the Department has allowed a company to record pension and/or PBOP deferrals to avoid a potentially substantial charge against its equity. See, e.g., D.T.E. 03-47-A at 36-40; D.T.E. 03-40, at 307-308.

In D.T.E. 02-83, the Department authorized Fitchburg to record a regulatory asset for its current and future Additional Minimum Liability. The recording of the regulatory asset allowed the Company to avoid a $4.2 to $4.6 million charge in 2002, which would have resulted in a reduction to Fitchburg's total common equity of approximately 15 percent (Exh. FGE-1, exh. LMB-1, at 20). In addition, in D.T.E. 03-131, the Department permitted the Company to begin deferring the difference between its actuarially-determined pension and PBOP costs and the amounts collected in base rates. These deferrals permitted Fitchburg to delay recognition of an additional $1.5 million of pension and PBOP expenses, about 15 percent of the total O&M expenses collected by Fitchburg in base rates (id.). In order for the Company to continue to record these deferrals on a going-forward basis, SFAS 71[13] requires that the Company's regulatory deferrals be probable of recovery within a reasonable

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13 In December 1982, the Financial Accounting Standards Board issued SFAS 71, effective 1983, which established standards for accounting for the effects of certain types of regulation. SFAS 71 sets forth the specific criteria that must be met for a regulated company to establish a regulatory asset (Exh. DTE-3).

period (Exh. DTE-3, at 6-7; Tr. at 96). The Company, and its auditors, Grant Thornton, define the reasonable period as three to seven years (Tr. at 102).

The Attorney General argues that the Company seeks to recover additional rate base costs incurred just days after the beginning of the rate year established in its last base rate case (Attorney General Brief at 3). The Company, however, is not requesting a base rate increase based upon overlapping test years, nor is it seeking to relitigate issues from D.T.E. 02-24/25. On the contrary, the base rates approved in the Company's last rate case will remain unchanged if the Department adopts Fitchburg's proposed PAF. The Company's proposal will, however, allow for the recovery of pension and PBOP costs not currently being recovered in rates through the PAF, will eliminate the need for recurring rate cases resulting from changes in pension and PBOP costs, and is consistent with the Department's recent precedent regarding the recovery of these costs. D.T.E. 03-47-A at 19-28; D.T.E. 03-40, at 308-309.

The Attorney General also argues that the Company has not demonstrated that it will suffer financial harm without the PAF (Attorney General Brief at 5). Without the Department's approval in D.T.E. 02-83 to establish a regulatory asset for its Additional Minimum Liability, the Company would have been required to record an expense of $4.6 million in 2002, resulting in a reduction to its common equity of 15 percent (Exh. FGE-1, exh. LMB-1, at 20). Further, absent the Department's approval, in D.T.E. 03-131, to defer pension and PBOP costs in excess of amounts recovered in base rates, Fitchburg would have incurred an additional expense in 2004 of approximately $1.5 million, which is about 15 percent of the total O&M expenses presently collected by Fitchburg in base rates (id.).

Moreover, the Company would have been required to recognize $284,008 in an after tax write-off for its 2003 pension and PBOP deferrals, which is approximately ten percent of the distribution return on equity allowed by the Department in D.T.E. 02-24/25 (Company Reply Brief at 9, n.2, citing Exh. DTE-9). These write-offs are of sufficient magnitude to have a material impact on the financial well-being of the Company and translate directly into higher borrowing costs, higher rates, and a potential disruption in service (Exhs. FGE-1, exh. LMB-1, at 12, 20, 22; DTE-5; Tr. at 73).

Finally, the Attorney General claims that the Company's cost reductions of $920,000 resulting from a management restructuring and reorganization plan eliminate the need for the pension adjustment mechanism (Attorney General Brief at 5).[14] First, Unitil Corporation's reorganization was initially considered in November of 2002, and not implemented until December 12, 2002, after the Department's decision in D.T.E. 02-24/25 (RR-AG-1). Fitchburg's allocable share of cost reductions resulting from the management restructuring plan were not "known and measurable" adjustments to the Company's test year cost of service when the Department issued its order in D.T.E. 02-24/25 and, therefore, would not have been a relevant factor in our decision in that case. Massachusetts-American Water Company, D.P.U. 95-118, at 130-131 (1996). Second, the Attorney General's allocation to the Company is incorrect because it improperly assumes that all savings occurred at Unitil Services (Tr. at 39). Rather, these savings were incurred in varying degrees, by all of Unitil

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14 The $920,000 represents 40 percent of Unitil Corporation's total estimated savings of $2.3 million allocated to Fitchburg (Attorney General Brief at 5, n.3).

Corporation's affiliates, including Fitchburg (RR-AG-1, at 1-2). To the extent that savings were incurred directly by, and only affected Unitil Corporation's New Hampshire operations, none of those savings would be expected to flow to Fitchburg. Furthermore, the $2.3 million in savings cited by the Attorney General represents total cash savings and would be divided between operating expenses and capital projects (RR-AG-1; Tr. at 33). Accordingly, to the extent that these savings reduce capital expenditures, Fitchburg's allocable share of these savings would not immediately result in reduced operating expenses.[15] Moreover, increases in O&M expenses incurred in 2003, a portion of which are allocated to Fitchburg, would more than offset any management restructuring savings (Exh. AG-6, at 20; RR-AG-1).

In conclusion, the Department allowed Fitchburg to record pension and PBOP deferrals to avoid a potentially substantial charge against its equity but Fitchburg still must address the SFAS 71 requirement that the Company's regulatory deferrals be "probable of recovery" within a reasonable period of time. Consistent with our precedent, the Department finds that it is appropriate for us to consider a pension adjustment mechanism that permits the recovery of the Company's deferrals.

B. Reconciling Mechanism

The Company proposes to recover its pension and PBOP costs not currently recovered through base rates through the PAF, which consists of three components: (1) a Reconciliation Adjustment, representing the difference between pension and PBOP costs recorded for

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15 Savings associated with reduced capital expenditures would manifest themselves over time by way of lower depreciation expenses.

accounting purposes in excess of the amount collected in base rates for those costs, amortized over a three-year period; (2) Carrying Charges on (a) prepaid or accrued pension and PBOP deferrals and (b) unrecovered reconciliation deferrals; and (3) a Past Period Reconciliation amount, consisting of the difference between the prior period's PAF revenues and the PAF for that prior year, with interest calculated on the over collection or under collection at the prime interest rate (Exhs. FGE-1, exh. LMB-1, at 26-27; DTE-9, at 4; Tr. at 9-11). The sum of these three components is divided by the forecasted sales units to arrive at the PAF for the upcoming year (Tr. at 11).

Although the Attorney General argues that the Company does not need the reconciling mechanism, we are persuaded otherwise. First, as previously noted, the Company must recover its pension and PBOP deferrals within a reasonable period of time to comply with the requirements of SFAS 71 and avoid detrimental financial consequences (id. at 102). The Company's proposal accomplishes this result (Exh. FGE-1, exh. LMB-1, at 22). Second, Fitchburg has established the presence of all factors that we have considered in the past in determining that an item should be collected through a reconciling mechanism: the magnitude and volatility of the pension and PBOP costs; the role of accounting requirements rather than the Company's actions on the pension and PBOP expense volatility; and the effectiveness of the reconciling mechanism in avoiding the negative effects of the pension and PBOP volatility (id. at 18-19).

The Attorney General also argues that if we allow a reconciling mechanism, we should include modifications. Specifically, the Attorney General argues that the Company should use an expected return on plan assets of 11.3 percent to calculate its annual pension and PBOP costs, or in the alternative, the Department should lower the Company's ROE (Attorney General Brief at 10). With respect to the 11.3 percent return, the Attorney General's proposal erroneously assumes that pension plans invest only in equity investment, and relies upon the results of a financial model which was rejected by the Department in Fitchburg's previous rate proceeding. See D.T.E. 02-24/25, at 238. Additionally, the Company's 2003 SFAS 87 pension cost was determined, in part, based upon an expected return on plan assets of 8.75 percent (Tr. at 64-65; RR-AG-3). The 8.75 percent expected return on plan assets relied upon by Fitchburg to calculate its pension expense is a composite figure arrived at by the Company and its actuaries, bankers, accountants and other consultants (Tr. at 53, 65). We find the projected 8.75 percent return on plan assets is supported by the evidence and reject the Attorney General's modification. With respect to the Attorney General's suggestion that the Department reduce Fitchburg's ROE, we find this request also is unsubstantiated and inconsistent with our precedent. D.T.E. 03-47-A at 38-39.

The Attorney General also claims that the PAF should not include the Carrying Charges component. He claims that the Company removed its cost of service pension income from its trust fund in its last rate case (Attorney General Brief at 9). Pension expense in the Company's last rate case, however, was determined based upon the Department's precedent at that time, i.e., tax-deductible cash contributions to its pension plan. D.T.E. 02-24/25, at 111-112. Because the Company was not eligible, under IRS rules, to make any such contributions to its pension plan during the test year, the Department allowed zero pension expense for ratemaking purposes. D.T.E. 02-24/25, at 111-112. This was accomplished by removing from cost of service the interest income earned on the Company pension fund recorded for accounting purposes. D.T.E. 02-24/25, at 110-112. Had the Company recorded pension expense during the test year, rather than pension income, that expense would have been similarly removed in computing the cost of service because, as noted, pension expense recovery for ratemaking purposes was, at that time, based upon tax-deductible cash contributions to a utility's pension plan. Accordingly, the removal of pension income from the test year in the Company's last rate case is irrelevant to whether carrying charges should be allowed in this case. Rather than require the Company to absorb the carrying charges associated with funding pension and PBOP prepaid and deferral amounts, we reject the Attorney General's proposed modification and allow the Carrying Charges component, which is consistent with our recent precedent in previous cases. See, e.g., D.T.E. 03-47, at 37; D.T.E. 03-40, at 311.

The Company has demonstrated a need for a reconciling mechanism and that it is in accord with our recent precedent. We will allow the Company to implement the proposed PAF, as modified by § V.C of this Order, below.

C. Modifications to Company's Proposal

The amortization of the PBOP transition obligation is included in the PAF, in its entirety, as a current operating expense (Tr. at 57-58). In computing the Reconciliation Adjustment, Fitchburg did not capitalize any portion of the annual amortization of its PBOP transition obligation (Exh. DTE-11). The Company states that it separates the PBOP amortization amount from the amounts chargeable to construction projects in order to avoid charging current construction projects for prior period costs (id.). The Company's failure to capitalize a portion of the annual amortization of the PBOP transition obligation is inconsistent with its treatment of similar labor and labor-related costs (Exh. DTE-8). As proposed, Fitchburg's 2004 Reconciliation Adjustment is higher than if a portion of the transition obligation had been appropriately capitalized. That result is unacceptable. Therefore, the Department directs the Company to capitalize a portion of the amortization of the PBOP transition obligation in computing the 2004 reconciliation adjustment using the same capitalization ratios as for other pension and PBOP costs (RR-DTE-1).

Further, the Company fails to allocate any pension and PBOP expenses to its transmission function (Exh. AG-4). The Company's failure to allocate any of the pension and PBOP expenses to its transmission function overstates the PAF.[16] Therefore, we direct the Company to allocate its pension and PBOP expenses between the transmission and distribution function.[17] See D.T.E. 02-24/25, at 234-235.

We also adjust the Carrying Charges component of the reconciliation mechanism with respect to the prepaid pension and PBOP amounts and/or accrued pension and PBOP liability amounts. Unitil Services bills Fitchburg for pension and PBOP expenses each month, and Fitchburg records those charges as operating expenses on its books (Tr. at 105). Accrued

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16 Increases in pension and PBOP costs allocable to the transmission function that have occurred since the Company's last rate case would be included in the PAF because there has been no increase in transmission revenues to offset the higher costs.

17 This directive applies to the prepaid pension and PBOP expenses in the Carrying Charges component of the PAF.

pension and PBOP amounts result from recorded expenses for accounting purposes being greater than tax-deductible contributions made to the respective plans (id. at 71). Because Unitil Services' balance sheets are carrying pension and PBOP accruals, we conclude that Unitil Services has recorded, and billed to its affiliates, greater pension and PBOP costs than it was required to pay to its pension and PBOP plans. Because Fitchburg's customers paid their allocable share of those expenses, Fitchburg's customers must receive credit for those payments in computing carrying charges on net prepaid pension and PBOP amounts minus the associated deferred income taxes, calculated based upon a rate of 38.03 percent (Exh. DTE-9, at 4, lines 16 and 21). Moreover, the Company will be required, in its next pension and PBOP filing, to provide a reasoned explanation for the accrued pension and PBOP liabilities of Unitil Services.

D. Operation of Mechanism

The Department will allow the reconciling mechanism to operate in the following way. The Company will file an annual pension adjustment mechanism, including a reconciliation of its PAF and actual recovered amount. For the gas division, the filing shall be made annually in conjunction with its LDAC filing on September 15;[18] for the electric division, the filing shall be made in conjunction with its annual December 1st reconciliation filing. The PAF will become effective on November 1 for the gas division and on January 1 for the electric

18 Thus, the Company will have to revise its current LDAC filing made on September 17, 2004.

division.[19] The PAF for the gas division will be collected from, or refunded to, all customers through the Local Distribution Adjustment Factor on an equal cents per therm basis over the following twelve months. The PAF for the electric division will be collected from, or refunded to, all customers through the KWH delivery charge on an equal cents per KWH basis over the following twelve months. The Company shall apply the prime rate on its reconciliation of forecast recovery to actual recovery consistent with 220 C.M.R. § 6.08(2).

VI. ORDER

Accordingly, after due notice, hearing and consideration, it is

ORDERED: That the tariffs M.D.T.E. Nos. 119 (Gas Division) and 112 (Electric Division), filed with the Department on April 16, 2003 by Fitchburg Gas and Electric Light Company to become effective November 1, 2004 be and hereby are DISALLOWED; and it is

FURTHER ORDERED: That Fitchburg Gas and Electric Light Company shall file new tariffs, to become effective November 1, 2004, that are in compliance with this Order; and it is

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19

	Gas Division	Electric Division
Reporting Year	November 1- October 31	January 1 - December 31
Filing Date	September 15	December 1
Effective Date	November 1	January 1

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FURTHER ORDERED: That Fitchburg Gas and Electric Light Company shall follow all directives contained in this Order.

By Order of the Department,

/s/
Paul G. Afonso, Chairman

/s/
James Connelly, Commissioner

/s/
W. Robert Keating, Commissioner

/s/
Eugene J. Sullivan, Jr., Commissioner

/s/
Deirdre K. Manning, Commissioner

Appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part.

Such petition for appeal shall be filed with the Secretary of the Commission within twenty days after the date of service of the decision, order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of twenty days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed, the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of said Court. (Sec. 5, Chapter 25, G.L. Ter. Ed., as most recently amended by Chapter 485 of the Acts of 1971).